DEPARTMENT OF STATE REVENUE

01-20170351.LOF

Letter of Findings Number: 02-20170351
Corporate Income Tax
For Tax Years 2013-2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Company was properly denied research tax credits; Company did not provide contemporaneous and sufficient documentation to substantiate the credit.

ISSUES

I. Adjusted Gross Income Tax–Applicable Law; Research Credits.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3.1-4-2; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930); *Union Carbide Corp. and Subsidiaries v. Comm'r*, T.C. Memo 2009-50 (U.S. Tax Ct. 2009); *Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454, 489 (1998); 45 IAC 3.1-1-66; 45 IAC 3.1-1-2; 45 IAC 3.1-1-7; I.R.C. § 41; I.R.C. § 174; I.R.C. § 1366; Treas. Reg. § 1.41-4; Treas. Reg. § 1.174-2; H.R. Conf. Rep. No. 106-478; TD 8930; Black's Law Dictionary (9th ed. 2009); *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784; 69 F.R. 22-01; 66 F.R. 66362-01; *Audit Technique Guide: Credit for Increasing Research Activities* (June 2005).

Taxpayer protests the disallowance of claimed research credits.

II. Tax Administration–Penalty.

Authority: IC § 6-8.1-10-2.1; *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012).

Taxpayer protests the imposition of a penalty.

STATEMENT OF FACTS

Taxpayer manufactures food products for various customers. Taxpayer has multiple shareholders; Taxpayer elected to file as an S Corporation. The Indiana Department of Revenue ("Department") conducted an income tax audit, reviewing Taxpayer's income tax returns "for the fiscal years ending 9/30/2012, 9/30/2013, 9/30/2014, and 9/302015." The Audit Report states that "for 9/30/12, the statute had expired during the course of the audit." Taxpayer, for the years of the audit, claimed an Indiana research expense credit. As a result of the audit, the Department determined that Taxpayer had failed to establish that it qualified for the research and development tax credit.

Taxpayer protests the Department's disallowance of the Indiana research credit. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax–Applicable Law; Research Credits

DISCUSSION

One of the primary questions is, for the years at issue, whether Indiana's version of the Research Expense Credit imposes the T.D. 8930 "Discovery Test" or the less restrictive T.D. 9104 "Uncertainty Test." Taxpayer takes issue with the both Treasury Decision 8930 and 9104, stating:

> In addition to the regulations promulgated by TD 8930, the auditor consistently cites the regulations promulgated by TD 9104 and the Audit Techniques Guide (ATG) throughout the Explanation of Adjustments. Neither of these sources has any binding authority on determining the REC during the examination period.

Taxpayer further argues that:

> The regulations that must be used to interpret the REC provisions found in Internal Revenue Code (IRC) § 41 are those promulgated by TD 8251. Although TD 8251 had an original effective date of June 20, 1981 to January 1, 1990, Congress extended the research credit fifteen times from 1985 through 2014. As a result, the regulations contained in TD 8251 remained in effect until they were replaced by TD 8930 on January 3, 2001. Consequently, the TD 8251 regulations were in effect on January 1, 2001 and must be used to interpret IRC § 41 during the examination period.

The Department maintains the applicable regulations are found in Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)); *see also United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009) (citing *Stinson Estate*) ("[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed."); *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor[e] can any particular deduction be allowed.")

In order to obtain the benefit of the RECs at issue, both Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). Moreover, Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in IC 6-3.1 which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question - provides:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

The issue is which regulations were in effect at the time the Indiana legislature promulgated IC § 6-3.1-4-4: T.D. 8251 (eff. May 16, 1989); T.D. 8930 (eff. Jan. 3, 2001); or T.D. 9104 (eff. Jan. 2, 2004).

Taxpayer challenges the validity of the IC § 6-3.1-4-4 reference to the 2001 federal regulations. This reference to the 2001 I.R.C. and regulations was added by P.L. 192-2002, § 89 in 2002, which was the first time that IC § 6-3.1-4-4 referenced a specific date. The Department has historically applied the 2001 final regulations, published under T.D. 8930 (the "2001 Final Regulations"). The 2001 Final Regulations define qualified research and development under I.R.C. § 41 to include a discovery requirement. However, these regulations were not promulgated until January 3, 2001, not January 1, 2001 (the date referred in the statute), and no portion of the regulation was made retroactive.

T.D. 8930, published in the Federal Register on January 3, 2001, contains final regulations relating to the computation of the research expense tax credit under section 41(c) and the definition of "qualified research" under section 41(d). "These regulations reflect changes to section 41 made by the Tax Reform Act of 1986 (the 1986 Act), the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998 (the 1998 Act) and the Tax Relief Extension Act of 1999 (the 1999 Act)." T.D. 8930, 66 F.R. 280-01. The 2001 Final Regulations set forth the discovery requirement for defining qualified research under I.R.C. § 41(d). Section 1.41-4(a)(3)(i) of the 2001 Final Regulations states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

T.D. 8930, 66 F.R. 280-01 at 290.

T.D. 8930 notes criticism by commentators to the proposed regulations (published in 1998) that this definition imposes a "discovery requirement" that was not mandated by I.R.C. § 41(d); however, the IRS and the Treasury Department elected to retain the Discovery Test because they "continue[d] to believe that section 41 conditions credit eligibility on an attempt to discover information that goes beyond the common knowledge of skilled professionals in the particular field of science or engineering" and that the legislative history of the Tax Reform Act of 1986 (the "1986 Act") supported such a definition. T.D. 8930, 66 F.R. 280-01. T.D. 8930 further explains that the 1986 Act narrowed the definition of the term "qualified research," and cites to legislative history explaining that "Congress was concerned that taxpayers had applied the original definition of qualified research 'too broadly,'" and under the 1986 Act research must be undertaken "*to discover information* that is technological in nature . . . ." *Id.* at 282 (quoting H.R. Conf. Rep. No. 99-841, at II 71 n.3 (1986)).

T.D. 8930 additionally notes that the discovery requirement is consistent with the legislative intent of the 1999 Act. The legislative history of the 1999 Act states "[e]mploying existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken *for purposes of discovering information* and satisfy the other requirements under section 41." *Id.* at 283 (quoting H.R. Conf. Rep. No. 106-478, at 332) (*emphasis in original*). T.D. 8930 states:

> By referring separately to a requirement that the research be undertaken for purposes of discovering information, this legislative history again confirmed that the phrase "discovering information" is a separate substantive requirement and not merely a phrase used to link the term *research* with the types of information required as the subject of the research.

Id.

T.D. 8930 also refers to case law applying the Discovery Test subsequent to the 1986 Act and prior to promulgation of the 1998 Proposed Regulations and the 2001 Final Regulations. In *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998), the Seventh Circuit relied upon the plain language of § 41(d)(1)(B)(i) and the legislative history of the 1986 Act in determining that the taxpayer had not engaged in "qualified research" because it did not develop research programs for the purpose of discovering information. The Court stated, "Congress clearly intended . . . that qualifying research pass a high threshold of innovation and be of broad effect." *Id.* at 444; *see also Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454, 489 (1998) (relying upon "ordinary meaning of the language used in the statute . . . as well as the legislative history surrounding the promulgation of the TRA 1986[.]").

Thus, T.D. 8930 clearly reflects the fact that the Treasury Department and the IRS considered the criticisms of the Discovery Test, yet chose to retain the requirement "[i]n light of the case law and the legislative history[.]" T.D. 8930. The 2001 Final Regulations did not spontaneously implement the Discovery Test, but instead rely upon legislative, statutory, and case law guidance evidencing that Congress intended to implement such a test with the

enactment of the 1986 Act, and reiterated this position in the Tax Relief Extension Act of 1999 (the "1999 Act"). Because the interpretation of the 1986 Act and the 1999 Act by the IRS and courts, the "Discovery Test" was meant to be applied based on the statutory interpretation alone. Thus, Indiana's adoption of the "Discovery Test" is consistent with IRS and the Seventh Circuit interpretation of I.R.C. §41.

In response to taxpayer concerns regarding T.D. 8930, on March 5, 2001, the Treasury Department and the IRS published Notice 2001-19 announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784, 2001 WL 84197. Notice 2001-19 also provided that, upon completion of the review, the Treasury Department and the IRS would announce changes in the regulations in the form of proposed regulations. These proposed regulations were published in the Federal Register on December 26, 2001 (the "2001 Proposed Federal Regulations"). 66 F.R. 66362-01. The resulting 2001 Proposed Federal Regulations departed from the "Discovery Test" and instead implemented the "Uncertainty Test":

> Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

F.R. 66362-01 at 66363-64.

The final regulations, which replaced the "Discovery Test" with the current "Uncertainty Test" for defining qualified research under § 41(d), were promulgated on January 2, 2004 (the "2004 Final Regulations"). 69 F.R. 22-01, 2004 WL 18938.

The Indiana Legislature would presumably have been aware that the IRS and the Treasury Department were reviewing the 2001 Final Regulations shortly after their promulgation, by means of Notice 2001-19 published on March 5, 2001, and that there were concerns about the application of the Discovery Test. However, the Indiana Legislature, in 2002, *after* the 2001 Proposed Regulations eliminating the "Discovery Test" had already been published in December 2001, selected a date prior to these revised regulations. Had the Indiana Legislature intended to adopt the "Uncertainty Test" over the "Discovery Test" in the 2003 Indiana Statute, it could have either referred to a date after the promulgation of the 2001 Proposed Regulations, waited until after the final regulations were promulgated in 2004, or not referenced any date at all. The application of the discovery requirement was a reasonable interpretation of I.R.C. § 41(d) from the date the 1986 Act was enacted until the promulgation of the 2004 Final Regulations. Thus, for the years at issue the audit was correct in relying on the "Discovery Test" in determining whether Taxpayer's activities qualified for the research and expense credits. Taxpayer's argument that T.D. 8251 is applicable to the tax years at issue is misplaced. It is the Department's established position that T.D. 8930 applies to the Indiana REC prior to January 1, 2016. *See* Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016); 20170222 Ind. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015), 20150325-IR-045150065NRA.

Thus, the Department finds that Taxpayer's protest with respect to the interpretation of IC § 6-3.1-4-4 is denied. This Letter of Findings now turns to the issue of documentation.

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with its federal income and making certain adjustments. IC § 6-3-1-3.5. Income from an S corporation flows through to the individual shareholder's personal income and is reported by the shareholders on their personal income tax returns. *See* I.R.C. § 1366. *See* also 45 IAC 3.1-1-66; 45 IAC 3.1-1-2(14); 45 IAC 3.1-1-7(6). Simply stated, an S Corporation - such as Taxpayer's company - is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009). Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine an individual shareholder's tax liability. Any additional income received by the S-Corp as a profit passes through to the individual shareholders as income.

Taxpayer protests that the Department erred in denying the research and development tax credit for the years at issue. As stated above, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its tax liability. See generally, IC § 6-3.1 and IC § 6-3.5. One of the tax credits available under Indiana tax law is the Indiana Qualified Research Expense Tax Credit under IC § 6-3.1-4-1 *et seq.* The 2003 statute, which was effective until December 31, 2015, and is relevant to the tax years at issue (the "2003 Indiana Statute"), provides:

> The provisions of Section 41 of the Internal Revenue Code **as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001**, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

IC § 6-3.1-4-4 (2003) (**Emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code as **in effect on January 1, 2001**[.]" IC § 6-3.1-4-1 (2003) (emphasis added). "Qualified research" is defined in the Internal Revenue Code ("IRC") under section 41(d). IRC subsection 41(d) defines qualified research in pertinent part as follows:

> (d) Qualified research defined.-For purposes of this section-
> (1) In general.-The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174,
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature, and-
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).
> Such term does not include any activity described in paragraph (4).

26 U.S.C. § 41(d)(1).

This provision sets out a four-pronged test for qualified research: first, the research must have qualified as a business deduction under § 174. *See id.* § 41(d)(1)(A); second, the research must be undertaken to "discover information which is technological in nature." *Id.* § 41(d)(1)(B)(i); third, the taxpayer must intend to use the information to develop a new or improved business component. *Id.* § 41(d)(1)(B)(ii); and finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).

The three projects examined in the Audit Report are as follows:

> **Chili Concentrate:** Taxpayer states that a customer "engaged [Taxpayer] to develop a new chili concentrate." Per the Audit Report, Taxpayer believes it "meets the 4 part test" and that the "chefs and plant managers are engaged in a process of experimentation that is technological in nature . . . ."
>
> **Mac and Cheese:** Per the Taxpayer, another customer "engaged [Taxpayer] to develop a new mac and cheese recipe." Taxpayer, per the Audit Report, "believes they meet the 4 part test . . . ."
>
> **Broccoli Cheese:** According to Taxpayer, a customer "engaged [Taxpayer] to develop a new broccoli and cheese soup."

In order to qualify for the research and expense credit, a taxpayer must meet the four-part test listed above, provide documentation that it meets the test, and provide documentation that the credits earned are directly linked to qualified research. Further, even if a taxpayer meets all four parts of the four part test, a taxpayer must substantiate the cost under I.R.C. § 41. A taxpayer has to link specific employees to specific portions of the claimed research and development activities. A taxpayer must accurately calculate how much time any employee spent on any portion of the claimed research and development. Under IC § 6-8.1-5-4 "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability. . . ." In addition, Treas. Reg. § 1-41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

> Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the

regulations thereunder.

Thus, a taxpayer in Indiana claiming the research and development credit for the years January 1, 2003-December 31, 2015, must keep *contemporaneous* documentation.

Regarding documentation provided during the audit, the Audit Report states that Taxpayer "[i]nitially . . . only provided a one page spreadsheet of the wages and supplies taken for the credit." The auditor, after talking to Taxpayer's power of attorney (POA), stated that "the taxpayer did provide further information on 3 projects that were the largest each year." The Audit Report further states:

> One project was selected for three of the four fiscal years ending 9/30/2012, 9/30/2013, and 9/30/2014. A project was not selected for fiscal year ending 9/30/2015. The only additional information the taxpayer provided was a definition of the 4 part test and how each project fit within the 4 part test. The taxpayer also listed all the projects that were worked on for each year with a check mark next to each section of the 4 part test stating that the taxpayer met the 4 part test without any further detail.

The Audit Report also states:

> The taxpayer has provided some other additional information since this time on other projects to the extent that the taxpayer listed out each project and put a check mark stating each project met the four part test. They have also provided some additional information such as weekly reports of projects that were worked on for the weeks provided. These weekly reports showed who was assigned the project that week along with a summary of what they were supposed to work on that week. The weekly reports did not state how much time or expense were taken on the projects worked on and an amount could not be determined. The final documentation the taxpayer provided was affidavits of the taxpayer's employees.

The research and development credit is broken down into a four part test: (1) whether the expenditure can be treated as an expense under I.R.C. § 174; (2) whether the expenditure was part of an undertaking for the purpose of discovering information which is technological in nature; (3) whether the application is intended to be useful in the development of a new or improved business component; and (4) whether substantially all of the activities constitute elements of a process of experimentation. I.R.C. § 41.

The Audit Report went through the four part test as it relates to Taxpayer. The Audit Report concluded that "taxpayer failed to provide contemporaneous records of the research being conducted," and that "[t]here was not substantial documentation to substantiate the credit taken." The lack of proper documentation vitiates Taxpayer's argument and will be addressed below.

"The term 'qualified research' means research with respect to which expenditures may be treated as expenses under section 174. . ." I.R.C. § 41(d)(1)(A). I.R.C. § 174 states:

> A taxpayer may treat research or experimental expenditures which were paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to a capital account. The expenditure so treated shall be allowed as a deduction.

The Audit Report cites to Treas. Reg. § 1.174-2(a)(1). That regulation defines "research and experimental expenditure,"

> The term *research or experimental expenditures*, as used in section 174, means expenditure incurred in connection with the taxpayer's trade or business which represents research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorney's fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. **Uncertainty exits if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.** (*Emphasis original*) (**Emphasis added**).

The Audit Report stated, regarding this first part of the four-part test:

> This definition is broad and would seem to include any costs that pertain to eliminating uncertainty

> concerning product development as long as the information available to the taxpayer does not establish the capability or method for developing the product or the appropriate design of its products. However, the taxpayer only includes wages, and a small amount of supplies that were mostly for shipping samples to its customers. These expenses were not categorized as research and development costs. Since the taxpayer did not track or report these expenses as research and development expenses and merely made a guess as to how much supplies were used and what percentage of wages should be applied. The auditor was unable to verify the amount claimed on the returns for the research credit based upon the limited an[d] incomplete information that the taxpayer provided. As stated above, the amount of expenses that qualify under Section 174 test could not be determined by the auditor as the information that was provided was a guess.

Taxpayer's response to the Audit Report is that the "auditor's claim of insufficient documentation has nothing to do with the section 174 test . . . ." Taxpayer argues that the Audit Report is actually "challeng[ing] the Taxpayer's substantiation of qualified research expenses (QRE's) claimed in calculating the REC." Later in its protest letter Taxpayer argues that regarding documentation:

> Neither the IRC nor the Treasury Regulations, in effect as of January 1, 2001, imposed a specific documentation or recordkeeping requirement for the REC. Without specific statutory or regulatory guidance dictating documentation for the REC, the general provision for recordkeeping requirement under federal law is codified in IRC § 6001.

Regarding IRC § 6001, Taxpayer states that "[a]lthough [it] provides little guidance as to what is 'sufficient to show whether or not such person is liable for tax,' the statute does specifically state that a taxpayer shall 'render such statements' with regard to their tax liability." Taxpayer concludes that this language means that "oral or written statements by a taxpayer should be acknowledged and utilized to support positions with respect to its tax liability." Taxpayer also cites to *Union Carbide Corp. v. Comm'r*, T.C. Memo 2009-50 (2009 WL 605161) (U.S. Tax Ct. 2009) and *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009). In a memorandum prepared in 2016, Taxpayer's accounting firm concedes that "[d]etailed invoices are not generated specifically for the test kitchen or first run production batches[;]" nonetheless, the accounting firm, due to *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930), believes that "an estimate of the costs are acceptable." As will be seen below, this Letter of Findings is in agreement with the Audit Report that "[t]here was not substantial documentation to substantiate the credit taken."

Under Indiana law, "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability. . . ." IC § 6-8.1-5-4. In addition, Treas. Reg. § 1-41-4(d)(1) (2001) states that for taxpayer to receive the research and development tax credit, a taxpayer must:

> Prepare[] documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder.

And IRC § 6001 also states–in the clause prior to the one regarding rendering statements–that "[e]very person liable for any tax imposed by this title . . . *shall keep such records* . . . ." And Indiana's statute (IC § 6-8.1-5-4) has similar mandatory language–"must keep books and records . . . ." The affidavits provided by Taxpayer were signed in February of 2017; the audit reviewed "fiscal years ending 9/30/2012, 9/30/13, 9/30/2014, and 9/30/2015." Thus Taxpayer failed to keep *contemporaneous* documentation. Additionally, the affidavits provided are not detailed and sufficiently informative for the matter at hand. For example, one of the February 2017 affidavits states in part:

> For the period of October 1, 2011 to September 30, 2012, I was a direct supervisor of ["John Doe"], who served as Director of Quality Assurance. As his supervisor, I had first-hand knowledge of his activities and the time spent on such activities. In his role, he provided services noted in the attached supplement with respect to the projects also listed in the supplement. The time spent by [John Doe] engaged on these projects was 12[percent] of his total time.

The "Affidavit Supplement" then states "Services and Activities" such as "[d]etermine appropriate product specifications," "[d]evelop/create recipes and formulations for product," "[d]evelop new projects," among other services and activities. The affidavit supplement then lists the dates and projects, stating for example: "1. [Customer's] chili concentrate - reduce cook times." This affidavit is a post-hoc estimation with no real explanation

of how the percentage of time was arrived at, years after the project. In other words, Taxpayer has not supported these post-hoc estimates.

The Audit Report, citing "Treas. Reg. 1.41-4(d) (TD 8930)," which states in part:

> (d) Documentation. No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer–
> (1) Prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and
> (2) Satisfies section 6001 and the regulations thereunder.

Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585 at 294-5.

After looking at TD 8930, the *Audit Techniques Guide: Credit for Increasing Research Activities* (June 2005), and IC § 6-8.1-5-4, the Audit Report states: "the taxpayer has not provided records that substantiate the amounts reported on returns filed by the taxpayer. The taxpayer has not provided records that substantiate the amounts of the credits reported on its returns." Further, the Audit Report states "taxpayer has not provided this contemporaneous documentation or contemporaneous documentation to support the employee research participation percentages that it used to calculate the qualified research expenses (QRE's)."

The Audit Report notes that regarding the four part test, Taxpayer may have met some of the elements. For instance, regarding the technological in nature prong of the test, the Audit Report states:

> The taxpayer may have uncertainties in their product development, however it could not be determined that the taxpayer was discovering information that was technological in nature due to lack of record keeping on behalf of the taxpayer.

In fact, the Audit Report is replete with comments regarding the lack of documentation as it relates to the four part test:

> [T]he taxpayer could not tie projects to the amount of expenses taken or the amount of time spent on each project per employee to verify that substantially all their activities were a process of experimentation. The taxpayer does not have proper documentation to substantiate that the entire project as being a business component.

Regarding the business component portion of the test:

> The taxpayer may have failures in the process of making the finished product, but not at the business component level and no documentation was provided to support this.

And two further examples of the Audit Report discussing the lack of documentation illustrate the problem:

> The taxpayer was asked for additional records, however the only additional records that were provided were random statements as to what the taxpayer worked on, however there was no substantial evidence of how much time or who worked on each project to substantiate the credit be taken.

And:

> Since the taxpayer considers the entire project the business component and no additional documentation could be provided linking the QRE's claimed to each project, it could not be determined if it was possible to shrink back to any subset of the projects which could satisfy the four part test of IRC section 41(d).

As the foregoing analysis has shown, Taxpayer has not overcome the lack of proper documentation issues that are endemic to its protest. But even if, *arguendo*, the Taxpayer could provide proper documentation, there is still the issue of excluded activities under IRC 41. As the Audit Report states, "[t]here are certain research activities that are specifically excluded from qualified research under IRC section 41(d)(4)," namely "any research related to

the adaptation of an existing business component to a particular customer's requirement or need." The Audit Report then cites to the June 2005 *Audit Technique Guide: Credit for Increasing Research Activities*. That guide states in relevant part that the "exclusion applies if the taxpayer's activities relate to adapting an existing business component to a particular customer's requirement or need," and that "[a] contractor's adaptation of an existing business component to a taxpayer's particular requirement or need is not qualified research." *Audit Technique Guide: Credit for Increasing Research Activities* (June 2005) https://www.irs.gov/businesses/audit-techniques-guide-credit-for-increasing-research-activities-i-e-research-tax-credit-irc-41-qualified- research-activities (last visited January 17, 2018). The auditor found that:

> The taxpayer does this. The taxpayer uses preexisting recipes and changes them to the customers specific requirements. As previously stated, the taxpayer may lower the sodium content, or the fat content, or make the label organic to meet the customers needs. Samples are sent to the taxpayer's customers for them to verify if this is what the customer wants. As stated previously, the taxpayer recreates products for the customer to meet the customers specific needs which would not qualify as research.

Taxpayer's response, in summary, is that it may not be "inventing chili, but there are multiple recipes for chili" and that Taxpayer's formula for a specific chili for [Taxpayer's client] is a new formula and a new product." Taxpayer's argument is flawed, and can be shown by noting that by Taxpayer's logic adding *anything* to chili would be a new product. Additionally, Taxpayer makes an analogical argument that attempts to compare its chili to the creation of an electric car for purposes of IRC § 41. The Department does not find Taxpayer's analogy edifying or persuasive.

Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Tax Administration–Penalty.

DISCUSSION

IC § 6-8.1-10-2.1(j) states, "If a partnership or an S corporation fails to include all nonresidential individual partners or nonresidential individual shareholders in a composite return as required . . . a penalty of five hundred dollars ($500) per partnership or S corporation is imposed on the partnership or S corporation."

Taxpayer's protest states that it disagrees "with the auditor's decision to impose a $500 penalty per year for the failure to file [a] composite schedule." Per the protest letter, this was "due to the disallowance of the REC," with the auditor "determin[ing] that composite schedules were required to be filed with the Taxpayer's 2013 and 2014 Form IT-20S."

As noted *supra*, Taxpayer's protest regarding the REC was denied. No further argumentation was provided or developed regarding this issue by Taxpayer. A taxpayer is required to provide documentation explaining and supporting its challenge that the Department's denial is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Taxpayer has failed to meet its burden of proof under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest of the penalty is denied.

SUMMARY

Taxpayer's protest regarding the research and development expense tax credit is denied. Taxpayer's protest of the penalty is denied.

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